Audit's
MONTHLY NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

Realty Trust Review

For delivery Monday, July 12, 1971 VOL. II, No. 7

INDUSTRY TRENDS

TRUST SHARES FOR YOUR ATTENTION

RISING INTEREST RATES MAY BRAKE TRUSTS SHARES FOR THE NEAR-TERM

Now that major commercial banks have dropped the other shoe on a boost in the prime rate to 6%, the real question is whether interest rates will again ratchet to new records. We have said before that we do not foresee any major upmove before year end and see no reason to change that opinion. Short-term rates are merely coming back into the normal relationship with longer-term rates, as evidenced by the fact that long-term rates have not shown any sustained strength.

Most mortgage trusts say loan demand is firm to very strong, and with stability in interest rates, we expect that mortgage trust portfolio yields will show little more decline except for special situations. Trusts which have taken advantage of the falloff in rates to increase their leverage and maintain earnings per share should now be able to move forward aggressively. And trust ability to raise funds on favorable terms is growing. *American Century Mortgage* has just raised $22 million by selling convertibles with a 6 3/4% coupon, although the convertibles also carried warrants to purchase 506,000 shares. *Guardian Mortgage* is readying an offering of $30 million of subordinated debentures due in 15 years plus warrants for 900,000 shares. This is one of the few examples of straight non-convertible debt by trusts, putting Guardian into a select class of trusts with straight debt with *Continental*, *First Mortgage*, *Chase Manhattan Trust*, *Capital* ~~and~~ *Associated*.

While we thus expect resumption of earnings growth for many trusts, rising rates may also lower the capitalized value of dividends. For many shares, this will result in a standoff; for aggressively managed trusts, earnings growth should overcome the lower capitalized value.

KENNETH D. CAMPBELL, EDITOR AND PUBLISHER / **AUDIT** INVESTMENT RESEARCH INC., 230 PARK AVENUE, SUITE 555, NEW YORK, N.Y. 10017 (212) 725-1410

Published twice monthly on the second and fourth Fridays *Subscription $84 annually* *Group rates on request*

TRUSTS STILL HUNTING A 'BEST' WAY TO COMPENSATE ADVISORY COMPANIES

A general standard for compensating the advisory companies which handle daily operations for a majority of realty trusts is still very much an unsettled issue for the industry. A survey of compensation agreements by REALTY TRUST REVIEW, made in response to numerous inquiries, shows that many trusts only one or two years old have changed their compensation agreements at least once, and that some older equity trusts have turned to advisory companies to handle their affairs under varying compensation agreements.

The compensation agreements are of vital concern for shareholders, because the management or advisory fee typically is the largest single expense item (other than interest on borrowings) in a trust's income statement, and thus the fee's size can alter earnings per share dramatically.

The major unresolved issue is whether trust advisers should be paid for the results they produce or for the amount of assets they supervise. The compensation study underscores the inherent conflict between advisory company and shareholder interests in the matter of compensation: under a formula related solely to total assets, the management company has more to gain from aggressively leveraging trust assets through borrowings than shareholders stand to gain in increased earnings. This is so because the spread on borrowings (i.e., margin between interest costs and interest income) typically runs in the 3.0%-4.0% range. If the advisory company receives 1.2% of the gross assets as its fee, the margin to the shareholder is reduced and indeed, some shareholders have complained that they are in effect splitting the return on borrowings with the advisory company. Fees related to assets are well established in the mutual funds, where assets have appreciation potential and thus the fee acts as an incentive.

Most mortgage trusts are seeking to resolve this issue with a combined fee structure. The survey shows 57 of the 74 mortgage trusts now pay their advisory companies on a base percentage of assets under management plus an incentive fee based upon the return on shareholders' equity they produce. Conversely, 14 trusts--including the two very oldest mortgage trusts--*Continental and First Mortgage*--pay strictly according to assets and two--*Fidelco Growth Investors and Republic Mortgage Investors*--go to the other extreme and compensate the adviser strictly by the return on shareholders' equity generated.

Perhaps the most unusual fee arrangement among mortgage trusts is that of *Medical Mortgage Investors*, whose adviser receives a fee on net invested assets (essentially shareholders' equity) plus a return of 0.75% of assets supported by borrowings if the net return on these borrowings exceeds 1.5%. MMI's agreement perhaps goes farthest to resolve this inherent conflict.

Most incentive plans provide for the advisory company to share in 10% of net income exceeding a base return. That base return ranges from 7% to 10% in the 57 incentive agreements. And 8% is overwhelmingly favored as a base figure, chosen by 35 (or 61%) of the trusts. Six trusts have related incentive payments to the prime rate, some picking the month-end prime *(Barnett)*, or the highest prime *(Citizens & Southern)*, or the average prime *(Equitable Life Mortgage)* or the average prime plus 1% *(Fraser)*. The 57 incentive bases are:

Base	Number	Base	Number	Base	Number
7.0%	5	8.5%	2	Prime	6
7.5	1	9.0	4	Total	57
8.0	35	10.0	4	2-stage	(6)

The two-stage rates tallied above are a refinement designed to reward advisers for achieving higher return on shareholders' equity (abbreviated as ROE in the table on p. 4).

The six trusts with two-stage incentive fees are *C.I. Mortgage*, *Citinational Development*, *Lomas & Nettleton*, *Mortgage Trust of America*, *Unionamerica Mortgage and Equity Investment*. The Citinational agreement is fairly typical: the adviser receives 10% of ROE over 8%, plus 5% additional (or a total 15%) on ROE over 10%.

The two full-incentive agreements, at Fidelco and Republic, begin paying a fee of 0.5% for ROE of 5% and range to a full 1.5% if ROE exceeds ceilings of 14% and 12% respectively.

Incentive fee agreements contain other subtleties. None of those examined recognize the near-equity status of convertibles. In other words, no adjustment is made for potential conversion in determining whether the incentive fee is payable, even though most trusts with convertibles are required to adjust for full dilution in reporting to shareholders. Cf. Baird + Warner

The survey also shows that practice varies widely in calculation of the base fee. Originally this base fee was calculated only upon actual loans disbursed, but about two years ago some trusts began including the undisbursed portion of closed loans in the base. They reasoned that the adviser had done the evaluation work for the loan and should be paid for this effort, even though only a small part of the total loan commitment had been disbursed. The survey finds about two-thirds of mortgage trusts--49 of 74--now include undisbursed portions of closed loans in their compensation base. Practice varies but it appears that most do not count the undisbursed portion until one advance has been made. These trusts are indicated by the word "Yes" in the column headed "Incl. unfunded?" in the table

The rate applied to this base is overwhelmingly 1.0% or 1.2% on an annual basis. For nearly all trusts this rate is calculated and paid monthly, and in most trust documents is stated as a monthly rate (most commonly 1/10 or 1/12 of 1%). We have annualized all such rates in the following table for clarity. Base rates break down as follows, using the highest (or first bracket)

Base rate-%	1.2%	1.0%	0.96%	0.9%	0.8%	0.75%	0.6%	0.5%	Incent. & Spec.
Trusts using	29	28	2	2	1	5	1	3	3

The base rate, while important, must be judged in the context of division of trust expenses between adviser and trust. The division ranges over so many combinations that it was impossible to make any tally. And while the items included may vary, on balance the base rates tallied appear to be a meaningful guide to trust compensation.

Equity trusts are more and more turning to advisory companies, as this group becomes more aggressively involved in development. The survey shows little uniformity in fee schedules to date, with some like that of *Realty Income Trust* based on return on shareholders' equity and earnings per share. The RIT agreement is the only one in which earnings per share plays a prominent role.

Are trust advisory fees too high? There is no easy answer, because one trust with a great number of small loans will require high personnel costs per dollar of loan originated, while others making only very large loans will require lower costs. A year ago the Midwest Securities Commissioners Assn. (Blue Sky Commissioners) adopted new guidelines setting limits on advisory fees of trusts whose shares were sold in member states. These guidelines generally limit trust expenses (excluding taxes, interest and securities costs) to the lesser of 1.5% annually of net invested assets (total investments before depreciation reserves minus total liabilities), or 25% of net income before deduction of management and servicing fees, and excluding depreciation or capital gains or losses. These guidelines also provide for a trust whose advisory fee exceeds these limits in any one year to reimburse overages to the trust, and several trusts have already done so. The following table summarizes trust fees.

? ~~Do Survey?~~ No

July 12, 1971

SURVEY OF 85 TRUST COMPENSATION PLANS

Trust	--Base rate on RE invest.-- Ann.rate	Incl. unfunded?	Incentive fee	Special provisions
Alison Mtg.	1.2%	Yes##	10% of ROE over prime rate	None
Amer. Century	1.2	Yes	10% of ROE over 7%	None
Amer. Fletcher	1.0 to \$75 mil. 0.9 of \$75-\$150 mil. 0.75 over \$150 mil.	No	None	None
Assoc. Mtg.	1.2	No	10% of ROE over 8%	None
Atico Mtg.	1.2	Yes	10% of ROE over 8%	None
BT Mortgage	1.2	Yes	10% of ROE over 8%	10% of net cap. gains
Baird & Warner Mtg. & Rlty. Inv.	1.0 under \$35 mil. 0.75 over \$35 mil.	Yes	10% of ROE over 9% (incl. cv. debt)	10% of net real. LT cap. gains
BankAmerica Rlty.	1.0	Yes	10% of ROE over 8%	10% of net real. cap. gains
Barnett Mtg. Tr.	1.2	Yes	10% of ROE over prime rate at month end	None
Beneficial Std.Mtg.	1.2	No	10% of ROE over 8.5%	None
C.I. Mtg. Gr.	0.8	Yes	12% of ROE over prime plus 3% of ROE over prime rate plus 2%#	None
Cabot, Cabot & Forbes Land Tr.	1.0	No	10% of ROE over 8%	10% of net cap. gains
Capital Mtg.	1.2	No	10% of ROE over 10%	None
Chase Man. Mtg.	1.0	Yes	10% of ROE over 8%	None
Citinational Dev.	1.2	Yes	10% of ROE over 8% 5% of ROE over 10%	None
Cameron-Brown Mtg.	1.0	Yes	10% of ROE over 10%	10% of gross cap. gains; 25% of forfeited comm. fees
Citizens & So. Rlty	0.5 on LT assets 1.0 on ST assets 10% of cash flow on equities	No	10% of ROE over highest prime rate	10% of net real. cap. gains
Citizens Mtg.	1.2%	Yes	10% of ROE over 7%	None
CleveTrust Rlty.	1.0 under \$100 mil. 0.75 over \$100 mil.	Yes	10% of ROE over 8%	10% of net real cap. gains
Conn. Gen. Mtg.	1.2	Yes	10% of ROE over 8%	10% of real cap. gains
Colwell Mtg.	1.2 under \$50 mil. 1.0 over \$50 mil.	Yes	10% of ROE over 8%	None
Cont.Ill. Rlty	1.2	No	10% of ROE over 8%	None
Cont. Mtg.Inv.	1.2 on C&D loans 0.75 on FHA-VA	Yes	None	None
Cousins Mtg. & Eq.	1.0	Yes	10% of ROE over 8%	25% of forfeited comm. fees. 10% of net real cap. gains

Trust	--Base rate on RE invest.-- Ann.rate	Incl. unfunded?	Incentive fee	Special provisions
Diversified Mtg.	1.0	Yes	10% of ROE over 10%	10% of cap. gains
Dominion Mtg.	1.2	Yes	10% of ROE over 8%	10% of gross cap. gains
Equitable Lf.Mtg.	1.0	Yes	10% of ROE over avg. prime rate	0.2% servicing fee 25% of forfeited comm. fees
Fidelco Growth	Incentive only 0.5 to 1.5 based on ROE	No	0.5% to 1.5% of assets on ROE from 5% to 14%	None
Fidelity Mtg.	1.2	No	10% of ROE over 8.5%	None
*First Fidelity	0.2 of net assets; 5% of gross rental income		None	None
First Memphis Rlty	1.0	Yes	10% of ROE over 8%	10% of net cap.gains
First Mtg. Inv.	1.0 of mtg. loans 0.75 of FHA-VA	No	None	10% of standby com. fees. 10% of income and 10% of net cap. gain from equity investments
First of Den.Mtg.	1.2	Yes	10% of ROE over 8%	10% of net cap.gains
First Penn. Mtg.	1.2	Yes	10% of ROE over 8%	None
Fraser Mtg.	1.2	No	10% of ROE over avg. prime plus 1%	None Servicing not over ½%
Galbreath Mtg.	0.5	Yes	None	None Not over 25% of for. com. fee
Gen. Mtg. Inv.	0.75 under $50 mil. 0.625 of $50-$75 mil. 0.5 Over $75 mil.	No	None	None Not over 25% of for. comm. fees
Goodrich Inv.Gr.	1.2	No	10% of ROE over 8%	None Servicing fee not over 0.375%
Grt. Amer. Mtg.	0.5**	No	None	25% of standby comm. fees
*GREIT Rlty.Tr.	0.4 of holdings before deprec.	--	10% of income over 10.5% of equity plus accumul. deprec.+	10% of net realized cap. gains.
Guardian Mtg.	1.2	No	10% of ROE over 7%	None
Gulf Mtg.&Rlty	0.96	Yes	8% of ROE over 8%	9% of real. cap.gains
*Gen.Growth Prop.	0.5 under $250 mil. net assets 0.25 over $250 mil.	---	None	3% of total rent collections. 1.5% of net leases; 0.5% of renewals.
Heitman Mtg.	1.2	Yes	None	None
Hotel Inv.	0.9 under $40 mil. 0.75 over $40 mil.	Yes	8% of ROE over 9%	None
*Hubbard RE	4% of gross inc. subj. to limits	---	None	None

Trust	--Base rate on RE invest.-- Ann. rate	Incl. unfunded?	Incentive fee	Special provisions
Investors Rlty.	1.0 under $100 mil. 0.9 of $100-200 mil. 0.8 over $200 mil.	Yes	10% of ROE over 8% 5% of ROE over 10%	None
Larwin Mtg.	1.2	Yes	10% of ROE over 8%	None
Lincoln Mtg.	0.75 under $50 mil. 0.625 of $50-$75 mil. 0.5 over $75 mil.	Yes	10% of ROE over 8%	None
Lomas & Net. Mtg.	1.0 under $100 mil. 0.9 of $100-$200 mil. 0.8 over $200 mil.	Yes	10% of ROE over 8% 5% of ROE over 10%	None
M&T Mtg. Inv.	1.0	Yes	None	None
MassMutual Mtg.	1.0 under $300 mil. 0.75 over $300 mil.	Yes	10% of ROE over 8%	10% of net real. cap. gains
Median Mtg.	1.0	No	10% of ROE over 9% (after amortiz. of debt disc.)	10% of net real. cap. gains
Medical Mtg.	1.2% of net inv. assets plus 0.75% of debt if return on debt exceeds 1.5%	Yes	None	None
Midland Mtg.	0.75 under $50 mil. 0.625 of $50-$75 mil. 0.5 over $75 mil.	Yes	None	25% of forfeited comm. fees
*Mobile Home Com.	1.5 of net assets less trustee fees	No	None	None
MONY Mtg. Inv.	0.75	Yes	None	None
Mtg. Inv. Wash.	1.2	Yes	10% of ROE over 8%	None
Mtg. Growth Inv. (formerly Eastern Shopping Centers)	0.96	No	None	May receive normal brokerage comm. not exceeding 1%
Mtg. Tr. Amer.	1.0 under $100 mil. 0.9 of $100-$200 mil. 0.8 over $200 mil.	Yes	10% of ROE of 8%-12% 20% of ROE over 12%	None
*Mutual REIT	0.5	No	None	None
National Mtg.	1.0	No	10% of ROE over 10%	None
*National Rlty.	1.5 of lesser of net assets or fair mkt. value of net assets		None	None
No.Amer. Mtg.	0.6 under $75 mil. 0.5 of $75-$100 mil. 0.375 of $100-$150 mil. 0.25 over $150 mil.	No	None	Adv. many receive brokerage commissions
NW Mut.Life Mtg.	1.0	Yes	10% of ROE over 7.5%	10% of net cap.gains
Old Stone Mtg.	1.0	Yes	10% of ROE over 8%	~~None~~ Not over 50% of forfeit comm fees
PNB Mtg. & Rlty.	1.0 (Not over 50% of profit on borrowings)	Yes	10% of ROE over 8%	May receive servicing
Palomar Mtg.	0.5 of commitments	Yes	10% of ROE over 9%	None

Trust	--Base rate on RE invest.-- Ann. rate	Incl. unfunded?	Incentive fee	Special provisions
*Rlty. Inc. Tr.	0.5 of equity	No	12% of ROE from 8-10% 25% of ROE over 10%	None
Realty Refund Tr.	1.0	Yes	10% of ROE over 8%	10% of net cap.gains 15% of forfeited comm. fees
Republic Mtg.	Incentive only 0.5 to 1.5 based on ROE	No	0.5 to 1.5 of assets on ROE from 5% to 12%	None
State Mut.Inv.	1.2	No	None	None
Sutro Mtg. Inv.	0.75 to $50 mil. 0.625 of $50-$75 mil. 0.50 over $75 mil.	Yes	10% of ROE over 7%	None
Texas First Mtg.	1.0	Yes	10% of ROE over 8%	10% of net real cap. gains; not over 25% of forfeited comm. fee
Tri-South Mtg.	0.5 on perm. loans 1.0 on const. loans	Yes	10% of ROE over 8%	10% of extraordinary items and cap.gain
Unionam. M&E	1.0 under $100 mil. 0.9 of $100-$200 mil. 0.8 over $200 mil.	Yes	10% of ROE over 8% 5% of ROE over 10%	None
USF Investors	0.9	Yes	10% of ROE over 8%	10% of net cap.gains; Servicing fee of 0.15%
U.S. Lsg. RE	1.2 under $50 mil. 1.0 of $50-$100 mil. 0.8 over $100	No	10% of ROE over 8%	10% of net cap.gains
U.S. Rlty Inv.	1.0 under $50 mil. mtg.inv. 0.75 of $50-$100 mil. 0.5 of $100-$200 mil. 0.25 over $200 mil.	No	None	25% of forfeited commit. fees.
*Virginia REIT	Flat fee per sq. ft.	No	No comp. if net cash flow below 10% of cash inv.; 3/4% to 5.0% of cash flow from 10%-15%; 5% over 15%.	
Wachovia Rlty.	1.2	Yes	10% of ROE over 8%	None
*Washington REIT	0.375	No	None	Maximum incl. both trustee & advisory co
Wells Fargo Mtg.	1.2	Yes	10% of ROE over 8%	10% of real cap.gains
Western Mtg.	1.2	No	10% of ROE over 7%	None
*Wisconsin REIT	1.5 of net assets	NA	None	None

Notes: Col. 1: Generally applied to investments excluding cash and cash items. Where used ST=short-term loans, LT=long-term loans. Col. 2: "Yes" indicates undisbursed portions of closed loans and/or committed loans are included in base for fee calculation. "No" indicates only disbursements used. ROE: Return on average shareholders' equity, generally computed monthly. NA-Not applicable. *Equity trusts. **Plus reimbursement of expenses on trust's behalf. #Applied only after invested assets as defined reach $200 million after fiscal 1971. ##Only after first funding. +Only after deduction of basic fee.

COMMENTS ON TWO TRUSTS LIKELY TO CHANGE MANAGEMENTS SOON

They are *Western Mortgage Investors*, which is seeking affiliation with the $1 billion State Street Bank & Trust Co. of Boston, and *Security Mortgage Investors*, which may come under control of a major industrial corporation.

A smaller mortgage trust with $8.88 million equity and $11.68 million assets, WMI was founded in 1965 by William Blackfield, Honolulu developer and former National Assn. of Home-Builders president. The $10.38 million portfolio is invested 49% in permanent FHA-VA and conventional loans, 46% in construction and development loans, and the remainder in a leasehold. The plan calls for Mortgage Advisers, Inc., WMI's adviser, to become a subsidiary of State Street Boston Financial Corp., parent of the major Boston bank. A proxy statement is expected to be submitted to shareholders in August following various regulatory approvals. The adviser is owned by Blackfield, an associate Clarence R. Short, and Stephen Mead, the trust's executive vice president.

Control of Security Mortgage Investors (ASE) may pass to a major industrial corporation if talks currently underway are concluded successfully. The unannounced talks have been going on for some time and it is believed a resolution is near. It is understood that 46% of SMO shares held by North American Acceptance Corp., subsidiary of Transcontinental Investing Corp., would be sold to the major corporation. Transcontinental has been divesting some operations and recently agreed to sell the film-making operations of Sol Hurok to General Electric Co. TIC sponsored SMO through a rights offering to TIC holders in March 1969, retaining 46% of shares (IRS rules prevent its holding over 50%). SMO is a unique trust, investing in first and second mortgage home improvement loans. The portfolio of 34.8 million net after $14.0 million unearned discount at March 31 yields an approximate 12.5% and has an average life of seven years.

Shares of both trusts ran up following word that discussions were underway but have since settled back to about 7 3/4 for WMI and 18¼ for SMO (vs. highs of about 10 for WMI and 22 3/4 for SMO). At current prices WMI is appraised at 13.8 times the $0.56 (annualized) earnings of the May quarter, and would yield about 7.25%. SMO is priced at 22 times earnings for the March year and would yield a sub-par 4.6%. At these prices, both trusts appear to be discounting most near-term gains which might be expected to follow any management changes. The big attraction in both situations is the additional leveraging muscle of new sponsors. We believe it is reasonable to expect much more use of leveraging and much more aggressive loan acquisition stances by both trusts should the management changes occur. Benefits likely would not be apparent for two to four quarters, however.

STATISTICAL RECORD

Western Mtg. (Yrs. ended Feb.)			Security Mtg. (Yrs. ended Mar.)	
EPS	Div.		EPS	Div.
$0.48a	$0.52	1968	NO	NO
0.42	0.42	1969	NO	NO
0.48	0.36	1970	$0.66b	$0.50
0.62	0.53	1971	0.83b	0.85
1,000,300		Shares	3,278,359	
7 3/4 bid		Recent price	18 1/4 ASE	

a-Before $0.04 extraordinary item.
b-Fully diluted.

In general we caution against buying trust shares on the expectation of management changes. Reaction to takeovers has been mixed to date. Mortgage Investment Group shares rose from about 19 last August to about 36 currently following its name change to Continental Illinois Realty. On the other hand, Sutro Mortgage Investment Trust shares are essentially where they were when the adviser, Ralph C. Sutro Co., was sold to Crocker Citizens Bank. The major variable appears to be aggressiveness with which each capitalized on relations with the new parent. At present levels speculative holdings of both are acceptable, with our choice going to WMI as being the more reasonably priced.

Written as of noon Thursday July 8.